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General Business Conditions

THE continuing boom in general business activity and the upward pressure on prices reflect the public reaction to the war in Korea and have been based almost entirely on civilian buying in anticipation of increasing military demands later on. Only limited war contracts have been reported as placed thus far, and actual production of armament and supplies under the planned expansion of the defense program, now being more clearly defined, is not likely to be fully felt by the industries until 1951.

Meanwhile production generally has risen to new postwar records in response to the heavy demands of the public for consumption goods as well as durables. Steel output has held, despite some scarcity of scrap and the partial railroad strike, close to the rated capacity now exceeding 100 million tons annually and still being expanded. Automobile assemblies have run near their all-time high, representing an annual rate of over 9½ million cars and trucks, despite curtailment in some plants due to strikes, model changeovers, and material shortages. Production has been unusually active also in television sets, refrigerators, deep-freezers, stoves, vacuum cleaners, washers, driers, ironers, and other household appliances, as well as in textile, chemical, rubber, petroleum, lumber, and paper products. In many of these lines the pressure for deliveries is intense, substantial backlogs have piled up, shipments are being allocated, and new orders are carefully sifted.

Overall industrial production last month climbed to a new postwar record, according to the Federal Reserve Board, whose index based on the 1935-39 average as 100 was estimated for August at 204, representing a rise of 7 points over July, and 9 points over the previous postwar peak late in 1948.

These heavy demands and the prospect of increased military spending around the corner have accelerated and broadened the upturn in expenditures for new industrial plant and equipment already in progress prior to Korea. Railroads have placed large additional orders for freight cars, and machine tool builders booked the largest business in July for any month in five years.

Panic Buying Subsiding

The heavy current consumption of raw materials by the industries, plus anticipatory buying, and government stockpiling of strategic materials, have exerted a strong upward influence upon prices since the start of hostilities in Korea, although the rate of increase appears to be slowing down and individual price movements are becoming more mixed. The official index of 28 basic commodities, mostly industrial raw materials, rose about 13 per cent in July, but only an additional 6 per cent in August, carrying it 19 per cent higher than at the Korean outbreak. The broad index of 900 wholesale prices rose about 5 per cent in July, then only 1 per cent in August, due principally to the further increases in metals being offset by declines in a number

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of agricultural products. In two instances last month — rubber and tin — the rapid advance of prices was followed by wide-open breaks in the world markets. General cost of living, as measured by the consumers' price index, rose 1.4 per cent from mid-June to July.

Retail trade continues at a high level and August apparently was another record month in volume of sales (also in consumer credit increase) in automobiles and appliances. Panic buying, however, seems to be subsiding. Department store sales, which had registered gains over a year ago exceeding 40 per cent in the latter half of July, and over 30 per cent in the first half of August, showed an increase of only 12 per cent in the week ended August 19. Scare buying of groceries by the public has, according to the Supermarket Institute, practically ended. Levelling off in prices of used automobiles, and reduced volume of business following the rush during the summer are reported by the New York Used Car Dealers Association, which stated that prices of some of the more expensive cars are down 15 per cent since August 1.

One effect of the rise in prices and the cost of living has been to start a movement for higher wages. The rise in the consumer price index last month automatically brought about a 5 cents an hour pay boost for General Motors workers, in accordance with the wages-cost of living formula based on this index. The movement for wage increases was given further impetus by action of the Chrysler Corporation in granting voluntary pay increases of 10 to 15 cents an hour to shop workers and 7 per cent to salaried workers. Previously Ford had been asked by the auto union to consider wage increases in anticipation of the expiration of the present contract next January 1; and numerous other wage demands have been granted or are pending. While both General Motors and Chrysler have announced that no increases in car prices are contemplated at this time, there can be little doubt that any general rise in wages will be reflected in prices.

The Outlook

All this raises the question as to what is going to happen to our already strained economy when the war spending program really gets under way. It is evident that this question is worrying a great many people in Congress, and explains in part the agitation for imposition of all-out controls.

The answer to this is probably two-fold.

In the first place, the civilian boom appears to be based on exaggerated ideas as to the extent to which the flow of civilian supplies is likely to be cut into by the arms program. Indications are that many people, in their first reactions to the Korean war, envisioned curbs as drastic as those applied in an extreme emergency such as World War II. Gradually, however, this mood is passing, and people are beginning to realize that, barring a spread of the war to new areas, the productive capacity of the country is great enough to take care of the announced armament program, and still leave room to supply normal civilian demands in most lines, though obviously not the highly over-stimulated and abnormal demands that have prevailed recently. Manufacturers and merchants would do well to consider the extent to which this unusual spurt in consumer buying may represent business borrowed from the future.

Estimates presented to Congress by Secretary of Defense Johnson place the amount of steel involved in the supplemental defense appropriation, plus the amount in the original program, at about 4,000,000 tons, or some 4 per cent of total annual steel capacity. Copper requirements are put at 160,000 tons, or about 7 per cent of supply, and aluminum at 100,000 tons, or 14 per cent of estimated current production. While these would be large figures to add to current demand, they do not suggest any great deprivation on the part of the American people in adjusting civilian output and consumption downward to make room for the defense program.

The second answer to the question lies in the adoption of measures that will cut down people's spending. This can be done by making effective the credit and fiscal curbs outlined by the President in his message to Congress at the outset of the Korean crisis and in his mid-year Economic Report. It involves tightening consumer credit and particularly home mortgage credit, where the Government's program of sponsoring low down payments and easier credit terms generally has been so large a factor in the building boom now adding to inflationary pressures and absorbing great quantities of material needed for defense purposes. Thus far the Government has made only a beginning toward reversing its policy of excessively high mortgage loan ratios, and residential building contracts awarded during the first half of August, stimulated possibly by fears of material shortages and higher prices later on, surpassed the record rates of recent months and were 110 per cent higher than a year ago.

Curbing inflation involves also financing the arms budget on a pay-as-you-go basis — thus avoiding Treasury borrowing, with all its implications in expanding the money supply at a time

when public spending needs to be restrained. Though such a program means more taxes, there is still another and better way to spread the cost. One hears much these days about closing "tax loop-holes" but not enough about closing "expenditure loop-holes" — especially where such spending has pronounced inflationary effects, as in the case of public works, subsidies to promote building, and high support prices for farm products.

Succeeding articles in this issue deal further with these tax and budgetary questions, and with general credit policy.

Statement by the C.E.D.

In a statement issued August 28, the Committee for Economic Development, composed of leading representatives of American business and education, expressed adherence to the principle that the chief measures in combatting inflationary effects of armament spending should be in the area of fiscal, monetary, and debt policy.

Declaring that the general strategy for mobilization does not include the use of price controls, wage controls or rationing in a military program of the magnitude now in sight, the Committee went on to say:

> We believe that such measures are not only unnecessary now but would actually impede the nation's efforts to build up its military force, prevent inflation and strengthen our economy. Overall direct controls inevitably interfere with the process of production and distribution of goods. They reduce the flexibility and adaptability of the economy, weaken incentives, discourage attempts to increase supplies of scarce materials, and interfere with the growth of productivity. Their interference with the productive process is cumulative, and is especially dangerous in a long-drawn-out period of rearmament.

Fiscal, monetary, and debt measures, the Committee stated, are the appropriate means for attacking the problem because they can be effective. They do not involve government decisions about all the details of the economic system. They leave the economy as free as it can be to operate efficiently and to grow.

As a positive program for restraining demand, five principal steps were advocated for immediate action:

1. Curtail government non-military expenditures to the maximum possible extent, and achieve the greatest efficiency and coordination in military procurement.
2. Raise taxes, so that, as the military program absorbs production, taxes will withdraw income from private hands.
3. Conduct a savings program that will bring home to the American people their opportunity to support the military effort by sensible management of their private finances.
4. Take advantage of the continuing large maturities of federal debt to sell more bonds outside the banking system and reduce the supply of money.
5. Restrict credit to curtail the demands that are mainly financed by credit expansion — notably the demands for consumers' durable goods, for housing and for business plant, equipment and inventories.

Restraint on business borrowing is, the Committee pointed out, a function of the Federal Reserve authorities using their well-established powers over open market operations, rediscount rates and reserves to influence the lending power of the banking system. By reducing its holdings of government securities, and by other supplementary measures, the Federal Reserve can restrict the reserves of the banks. In this way, it can limit their ability to make loans and restrict the expansion, or force the curtailment, of the supply of money. Failure to use this instrument, the Committee warned, would leave open a means of financing excessive civilian expenditures and speculation and could largely undo the work of other demand-curtailing measures.

The statement concludes with the timely reminder that success of the program requires the voluntary support of the American people. While the present military program does not involve serious inroads upon the standards of living of the American people, it does mean, the report said, that we shall have to give up for a time the improvement in our standards of living that would otherwise have been possible. "The burdens we are called upon to bear are well within our capacities. However, we shall endanger our freedom and our security if we try to escape these burdens by participating in a scramble of hoarding, speculation, wage boosting and price boosting."

The Federal Tax Program

The prompt action by Congress in expediting a bill to increase federal taxes substantially, as recommended by President Truman following the outbreak of war in Korea, will have the effect both of providing an increase in Treasury revenues to cover the rising military expenditures and of acting as a brake upon the inflationary pressures now present. It was estimated that the increases contemplated in various tax rates would together produce an increase in tax revenues of $4½ to $5 billion, on an annual basis, but some tax experts anticipate that actual yields will be much greater, due to the rising tempo of business and higher levels of national income. Senator George, chairman of the Senate Finance Committee, is quoted as expressing the view that "by increasing the rates to pick up $5 billion on the

basis of the present economy, we actually will get $8 to $10 billion, because of the fast expanding economy."

The bill, as recently approved by the Senate Finance Committee, represents a complete revamping of the House-approved tax readjustment bill intended to cut back wartime excise taxes in line with – but to a greater extent than – tax recommendations made by the President in January. Following the outbreak of hostilities in Korea, Mr. Truman asked the Senate Finance Committee to replace the proposed excise cuts of the House bill with individual income tax increases, to retain revenue-raising provisions which would close "loopholes", and to raise the House-approved scale of increases in corporation taxes.

This is substantially what the Senate Finance Committee has done. Not only were the provisions for excise tax reductions deleted, but such taxes were extended to television sets, deep freezers, slot machines, and auction sales of furs and jewelry. Retention of certain provisions for closing tax "loopholes" is calculated to raise $300,000,000 of additional revenue. Of primary importance from both the revenue and business standpoint, however, are the increases made in the rates of income tax upon corporations and individuals, estimated to augment tax receipts by $1,500,000,000 and $2,700,000,000, respectively.

Corporate Tax Increases

An increase is made in the combined rate for normal and surtax on corporate income from the former 38 per cent to 42 per cent on 1950 income, and to 45 per cent on 1951 income. There are provisions for prorating the increase on companies having fiscal years ending on dates other than December 31, and for preferential treatment of the large number of small corporations by imposing on the first $25,000 of taxable income rates of only 23 per cent in 1950 and 25 per cent in 1951. This eliminates the objectionable "notch" provision of the former law, which had rates graduated upward applying to corporations with incomes under $25,000, but very high rates to bridge the gap between that figure and the $50,000 level at which the standard rates applied.

A rate of over 40 per cent on corporate income represents a new high for all time, except when excess profits taxes were added during World Wars I and II. Normal and surtax combined in the period 1942-45 was 40 per cent for the larger corporations, while in 1939 the rate was 19 per cent and in 1929 it was 11 per cent. When the Federal Government was first authorized by Constitutional amendment in 1913 to levy income taxes the corporate rate was but 1 per cent.

A novel provision introduced in this bill requires that corporations step up the proportion of their annual tax payments that are made during the first two quarters of the following year. Instead of paying, as heretofore, instalments of 25 per cent of the total tax each quarter, corporations after January 1, 1951 will pay 30 per cent of the total tax in both the March and June quarters, leaving 20 per cent in the September and December quarters. It is provided that in later years the payments in the first two quarters will be stepped up further, so that after five years they will be 50 per cent in both the March and June quarters, thus covering in full the payments due on the preceding year's income.

Through this feature, which has been advocated as putting corporations more nearly on a pay-as-you-go basis, collection of Treasury revenues would be accelerated without being increased in the long run. Corporations would be hit during the speed-up period by the double burden of having to pay more taxes under the increased rates and of having to pay them earlier.

A provision in the law designed to encourage business outlays for construction of new plants for the production of armament and related equipment provides, as did World War II tax legislation, for the amortization of such facilities for tax purposes at a rate of 20 per cent annually, rather than at the lower rates which apply generally and are based upon the estimated useful life of the assets. This accelerated depreciation charge in computing taxes would be available only on new properties certified as essential by the Government.

Rise of Individual Income Taxes

Individual income tax rates are raised practically back to the wartime peak, although the bill does not change the provisions adopted in 1948 for more liberal dependency allowances and for a split in the income of joint returns in computing the total tax payable, in accordance with the community property principle. While the increase takes place, theoretically, as of October 1, 1950, the tax payable on 1950 income will be computed on the total income for the full year 1950, with adjustment for the fact that the higher rates apply for only one-fourth of the year. This will avoid the complications of having to divide the year's income and to compute taxes on each part separately.

Withholding taxes on individual income will be raised, as of October 1, 1950, from 15 to 18 per cent, after the usual allowance for personal exemption and dependents.

Here again, as in the case of the corporate income tax, it is of interest to observe how rates of individual income taxes have tended to be pushed constantly and inexorably upwards from modest beginnings. Restoration of the wartime rate of 20 per cent on all income after a $1,200 exemption for a married couple contrasts with a 4 per cent rate in 1939 after an exemption of $2,500. When the federal individual income tax was first authorized in 1913, the normal rate was but 1 per cent after a personal exemption of $4,000, while the graduated surtax started only at $20,000 and rose to a maximum of but 6 per cent. Under the new bill, the combined normal and surtax rises to a maximum of 91 per cent.

1951 Tax Legislative Plans

In advancing the present tax bill, the Administration and Congress have recognized the desirability of framing a measure that would be as simple and non-controversial as possible, and that could be put into effect promptly for increasing government revenues and checking inflation. It was planned that this "interim" or "quickie" measure would be followed up after the first of the year by additional tax legislation which might be needed but would be of a more complicated and controversial nature.

President Truman has indicated that he intends to ask for a corporate excess profits tax, and there is much political pressure for this type of tax. This is true despite its many inequities, the difficulties experienced in its administration, and the dangers in imposing on the economy a tax which, in effect, penalizes progress, when the country is not engaged in a full-scale war but is in a period of stress that might conceivably last for years to come. Senator George in a recent interview spelled out more specifically the various proposals that might be considered to raise perhaps $7 billion in additional taxes next year, including a corporate excess profits tax, a tax on cooperative organizations, and a tax on increased income of individuals. A Congressional committee has been appointed to study and report on these and various other types of taxes, including a broad extension of the manufacturers' and excise taxes, and a universal federal sales or transaction tax.

This is a formidable program, and the Administration and Congress have been wise in deferring action for further study and mature consideration. The main thing at the moment is to get something upon which most people can agree and which will start substantial amounts of additional revenue rolling in. While sound policy demands that the Korean war and the expanded program of military preparedness be financed within the framework of a balanced budget, we ought not to be panicked into a tax program that is based on vague and possibly exaggerated ideas as to what the requirements really are.

Already the tax burden is so heavy that it is not easy to tighten the screws or find new sources of revenue without destroying individual and business initiative. For example, at the same time that Congress was framing the bill to increase taxes, the Department of Commerce issued a report showing that total taxes — federal, state, and local — in 1949 aggregated almost $54 billion, an average of $359 for every man, woman, and child in the country. For the average family of four, this means taxes (direct and indirect) of more than $27 a week.

By deferring further tax legislation until after the first of the year there will be opportunity for formulating a more solid judgment as to the amount and character of additional taxes that may be needed. By that time we should have a better idea of the size of the military program and the rapidity with which actual disbursements will be stepped up. We should be able to estimate more closely the revenues to be expected from current taxes, including the higher rates of the present tax bill which will then be effective. Finally, there will be opportunity to see what can be done by a prompt and vigorous effort to cut back government non-essential peacetime expenditures.

1951 and 1952 Budget Prospects

As an aid to thinking more concretely about the budgetary outlook and the problem of increased taxes, we present herewith some budget projections for the fiscal years 1951 and 1952. They are based on certain assumptions as to the rate of increase in actual military expenditures (including military aid to foreign countries), cutbacks in non-military spending, and increase in yields from taxes.

The figures in the first column give the estimated receipts and expenditures for fiscal 1951 contained in the President's January budget. Those in the second and third columns are based on assumptions as explained hereafter.

Hypothetical U.S. Government Budgets, Based on Certain Assumptions* Fiscal Years 1951-52

(In Billions of Dollars)

	1951		1952
	January Estimate	Assumed	Assumed
Expenditures:			
National defense	$13.5	$20†	$30†
International affairs and finance	4.7	4	2
All other	24.2	21	18
Total expenditures	42.4	45	50
Total receipts	37.3	45	48
Budget surplus or deficit	— 5.1	0	— 2

* Hypothetical budget assumes (a) increase in actual expenditures for defense and foreign military aid to $20 billion in fiscal '51 and to $30 billion in fiscal '52. (b) decline in expenditures for international economic aid, due to tapering off in economic recovery aid and increased emphasis on military aid. (c) cutting back all other expenditures to level of fiscal '48, and (d) increased revenues, due both to higher levels of business activity and national income, and to higher tax rates on individuals and corporations contemplated in the pending $5 billion interim tax bill. † Includes foreign military aid.

On the side of expenditures, it is assumed that actual outlays for national defense, estimated in the January budget at $13.5 billion for fiscal '51, will actually rise to something like $20 billion (including foreign military aid) this fiscal year and to perhaps $30 billion in fiscal '52. These are round numbers and, while no one can pretend to accuracy at this time, they are probably reasonable assumptions, based on the presently announced rearmament program and the inevitable lag in actual disbursements.

For international affairs and finance, it is assumed that expenditures might decline to $4 billion in fiscal '51 and to $2 billion in '52, due to tapering off in economic recovery aid and increased emphasis on military aid included in the national defense total.

In the case of "all other" expenditures, it is assumed that the country would be willing to tighten its belt and cut back these outlays to the levels of 1948, or to $18 billion. This would mean a reduction of $6 billion, spread over a two-year period, and could be achieved, if we have the determination to do it, by elimination of non-essential or postponable projects and the introduction of economies so clearly outlined in the Hoover Commission studies.

On this basis, the grand total of expenditures, estimated in January at $42.4 billion for fiscal '51, might be held to around $45 billion this year and $50 billion in fiscal '52.

On the revenue side, it is apparent that the higher rates of the interim tax bill, combined with the upward trend of general business activity and national income, will lift Treasury receipts in the current fiscal year far above the official budget estimate of $37.3 billion submitted in January. In the President's budget message at that time it was stated that the revenue estimates were made on the assumption that business would continue at its then prevailing level, which was around 180 (1935-39=100) as measured by the Federal Reserve production index. Since then, however, the boom in business has raised the index to above 200, and it might well rise considerably higher with the expansion of the defense program. Moreover, general prices are also higher, which will raise the dollar volume of trade and incomes.

Taking account of all these factors, revenues might be conservatively estimated to reach $45 billion in the fiscal year 1951, and around $48 billion in '52 when the new rates become applicable to a full year's business and income. It is interesting to note that these figures agree closely with the estimate by Senator George, cited earlier, that the new $5 billion tax bill, in conjunction with expanding economic activity, might actually increase Treasury receipts by as much as $8 to $10 billion.

As will be seen from the table, these projections would indicate a balanced budget in fiscal '51 and a deficit of only $2 billion in '52.

Slash in Nondefense Spending Imperative

These figures may come as a surprise to many people in view of all the billions of new spending being talked about and apprehensions as to deficits of $10 billion or more. The "catch" is partly in not allowing adequately for the lag in spending and for the jump in taxes on the expanding economy. While the imponderables are of course many and great, the figures may help to clarify thinking about the financial problem, to suggest its general order of magnitude barring further marked expansion in our military commitments, and to indicate various ways in which it might be met.

In arriving at these budget results an integral assumption has been that Congress and the Administration will make a determined effort to trim down the "fat" in the budget, and everyone knows there is plenty of it. Since the cut of $6 billion projected for "all other" expenditures envisions merely eliminating those increases since 1948, this should not involve an unwarranted sacrifice in view of the unavoidable increases in military expenditures and taxes caused by world developments. In some areas, such as farm and housing subsidies, substantial cutbacks will take place automatically as a result of the improvement in farm prices and the reduction of government purchases of home mortgages under the Administration's announced program for tightening mortgage credit. In other areas, it will

mean cutting back on new programs that had been proposed for this year, and on proposed expansions of existing programs.

It is logical and imperative that part of the increased defense costs be paid for in this way. The extent to which we are able to do this will be a measure of the courage of our political leaders, and of the ability of the people "back home" to see the seriousness of the issues and to place national above local interests.

Limits on the Federal Reserve

A correspondent writes us:

> What laws, rules, or regulations, are there to prevent the Federal Reserve Banks from buying the billions of U. S. Government obligations and issuing currency in payment thereof?

Inquiries along this general line appear in our mail frequently. Sometimes we are asked to calculate how many billions of government securities the Federal Reserve Banks can lawfully add to their holdings, which now amount to $18.6 billion. But however the question is phrased, the writer displays an awareness that such purchases are inflationary and a concern over the prospective purchasing power of his money. How much real protection will his life insurance afford for his dependents? What value are Savings bonds bought today going to have — in actual buying power — when they come due ten years hence? What is a $100 a month pension going to be worth at some future time when payments begin? The inflationary pressures growing out of the war in Korea give these questions an added importance.

Money loses purchasing power through overissue and all history points to extravagance in government as the number one cause of currency inflation. Meeting government expenses at the print shop has been a rival of war and famine among causes of human misery. The practice is discredited by experience. The better way has been to turn the powers of note issue over to a central bank subject to specific limitations and with a written or unwritten responsibility to keep its money good. Here peril crops when a central bank becomes or is made a tool of the spending departments of government.

A prudent citizen has certain grounds for misgiving. One is the wartime loss in the buying power of the dollar. Another is the tendency for the Federal Government to undertake spending commitments without reckoning where the money is coming from. Another is the heavy purchases the Federal Reserve authorities have undertaken from time to time to maintain the prices of government securities at some particular levels. When, as happened two weeks ago, the Treasury offers $13½ billion of securities which cannot be absorbed in the market without massive Federal Reserve buying, the time has come to reinspect the defenses against inflation of money and credit written into the Federal Reserve Act.

Direct Loans to the Government

The Federal Reserve Banks, under a temporary authority, can lend directly to the U. S. Treasury but here there is a specific limitation of $5 billion. This power of direct lending to the Treasury, granted in 1942 as a wartime measure, was employed on a number of occasions during the war and up to a maximum of $1.3 billion. Since the Victory Loan drive in December, 1945, the authority has been used on three occasions, most recently on June 15, 1950 when $105 million was borrowed for a single day. The direct lending authority recently was extended, by act of Congress, until July 1, 1952. While this power clearly has not been misused, Congress has expressed doubts from time to time as to the necessity and size of the power.

The matter that is of concern to our correspondent, however, is not direct lending but indirect lending by way of Federal Reserve purchases in the open market of government securities originally sold to somebody else. This indirect lending is just as inflationary as direct lending by the Federal Reserve to the Treasury.

The Federal Reserve Banks' authority to buy and sell government securities in the open market is stated in Section 14 of the Federal Reserve Act in the broadest terms: "Any bonds, notes, or other obligations which are direct obligations of the United States or which are fully guaranteed by the United States as to principal and interest may be bought and sold without regard to maturities . . . in the open market . . ."

Section 12A, added to the Federal Reserve Act in 1933, sets out a guiding directive:

> The time, character, and volume of all purchases and sales of paper described in Section 14 of this Act as eligible for open-market operations shall be governed with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country.

Here there is a kind of limitation. But words, of course, are flexible and can be bent to suit convenience. Statements of guiding principles, even though written into law, can never have the effectiveness of a specific limitation. Men faced with the responsibility of making wise but un-

popular decisions find the task easier when there are elements of compulsion to back them up.

The Specific Limitation

The specific limit on Federal Reserve Bank purchases of government securities in the open market is in their gold reserve requirements. Section 16 of the Federal Reserve Act requires that:

> Every Federal Reserve bank shall maintain reserves in gold certificates of not less than 25 per centum against its deposits and . . . Federal Reserve notes in actual circulation.

The reserve requirements set up in the original Federal Reserve Act were stiffer, 35 per cent against deposits and 40 per cent against note circulation, but these requirements were lowered to a uniform 25 per cent by Act of Congress on June 12, 1945. It should be noted in this connection that Section 11 of the Federal Reserve Act gives the Federal Reserve Board a power, designed for emergency, to suspend these reserve requirements for temporary periods.

The Potential

The present gold reserve requirements allow the Federal Reserve a very liberal margin for buying up government securities. On August 23, 1950 the Federal Reserve Banks had gold certificate reserves of $22.6 billion, and combined note and deposit liabilities of $41.1 billion. The ratio between gold and the combined liabilities – called the "Federal Reserve ratio" – was 54.9 per cent. By another calculation, as the following table shows, it can be ascertained that the gold reserve requirements are $10.3 billion (25 per cent of the $41.1 billion), so that $22.6 billion of gold certificates actually held give the Reserve Banks surplus reserves of $12.3 billion. Either the "Federal Reserve ratio" or the "surplus reserves" calculation indicates very large leeway for Federal Reserve purchases of government securities.

Legal Reserve Position,
Twelve Federal Reserve Banks Combined
as of August 23, 1950

Total gold certificate reserves		$22,569,850,000
Federal Reserve notes	$22,810,170,000	
Total deposits	18,276,797,000	
Deposit and note liabilities combined	$41,086,967,000	
Gold reserve requirement (25 per cent of $41,086,967,000)		10,271,741,750
Surplus reserves		$12,298,108,250
Federal Reserve ratio ($22,569,850,000 divided by $41,086,967,000)		54.9%

The leeway is even greater than the $12.3 billion of surplus reserves. When the Federal Reserve Banks buy government securities they do not, of course, pay for them in gold or gold certificates but rather in deposit credits on their books which are in turn convertible into Federal Reserve notes. Thus purchases of $12.3 billion government securities would not, in the arithmetic, reduce the gold reserve but would increase note and deposit liabilities in the same amount. The Federal Reserve Banks, theoretically, could buy up four times $12.3 billion – practically $50 billion – additional government securities before their note and deposit liabilities would reach the limit of expansion permitted by their present gold certificate reserves.

Sometimes people have carried the calculation further and have assumed that people who sold government securities would always deposit the proceeds in a private bank and then have figured how much the potential lending power of the banks would be increased. The overall inflationary potentialities grow almost beyond the reach of imagination – indeed they become quite infinite – if the further assumption is introduced that the Congress would go along with successive reductions in the gold reserve requirements or would acquiesce in their indefinite suspension by the Federal Reserve Board.

Gold Convertibility

In the past, maintenance of gold convertibility has exercised a restraint on Federal Reserve open market and discount operations. It could do so again. While an American citizen cannot demand gold from a Federal Reserve Bank in exchange for his money, a foreign government or central bank can. A reckless policy of buying up government securities in the open market, threatening the value of the dollar, could produce a drain of gold reserves. This would speed the decline in the Reserve Banks' surplus reserves, in the Federal Reserve ratio, and in the Federal Reserves' capacity to buy and hold more government securities. In other words, there is no fixed amount of gold that the Reserve Banks can always count on having, irrespective of the policies they pursue. There is this "joker" in theoretical calculations such as those given in the foregoing table.

In recent years it has been a rather common assumption in Federal Reserve circles that gold naturally gravitated to the United States in some regular fashion and that the U. S. gold reserves would continuously increase. The three-quarter billion decrease that has occurred since last September, as foreign nations have rebuilt their reserves, serves as a useful reminder that gold

can go out of the reserves as well as in – as it must if the metal is to serve as an effective currency base. This gold movement reflects measures that foreign governments and central banks have taken, with our aid, to strengthen their currencies. We are under a parallel necessity to avoid measures that threaten stability of the dollar. In fact, stability of the dollar is the essential basis for world monetary restabilization.

The Principal Threat

The principal threat to the dollar today lies in the unsatisfactory state of Federal Government finances with an unbalanced budget and an overload of floating debt. These lead to pressures on the Federal Reserve to support the market for government securities so that borrowings to cover the deficit, and to take care of maturing obligations, can be handled as cheaply as possible. The illusion is commonplace that we can have perpetually easy money without inflation. This environment is not a good one for the adoption of sound measures of restraint when they are needed. The Korean war, adding to inflationary pressures already present, puts to the test the will of government, and of the Federal Reserve, to adopt firm policies to protect our money from depreciation through overissue.

There are, fortunately, cool heads who appreciate the perils. Last January a Subcommittee of the Congressional Joint Committee on the Economic Report, under the chairmanship of Senator Douglas of Illinois, reported the following among other conclusions after a careful study of postwar monetary, credit, and fiscal policies:

> Timely flexibility toward easy credit at some times and credit restriction at other times is an essential characteristic of a monetary policy that will promote economic stability rather than instability.
>
> The vigorous use of a restrictive monetary policy as an anti-inflation measure has been inhibited since the war by considerations relating to holding down the yields and supporting the prices of United States Government securities.
>
> As a long-run matter, we favor interest rates as low as they can be without inducing inflation, for low interest rates stimulate capital investment.
>
> But we believe that the advantages of avoiding inflation are so great and that a restrictive monetary policy can contribute so much to this end that the freedom of the Federal Reserve to restrict credit and raise interest rates for general stabilization purposes should be restored even if the cost should prove to be a significant increase in service charges on the Federal debt and a greater inconvenience to the Treasury in its sale of securities for new financing and refunding purposes.

Treasury-Federal Reserve Conflict

These conclusions have not been effectively refuted from any quarter. Nevertheless, the Subcommittee report failed to receive the endorsement of the full Committee and met outspoken objection from the President's Council of Economic Advisers. The issue appears now in the difference of opinion between the Federal Reserve and the Treasury as to the current financing. To what purpose should the Federal Reserve use the broad powers over the volume and cost of money entrusted to them by the Congress? To make it perennially cheap and easy for the Treasury to borrow, in peace and war, boom or depression? Or, as Franklin D. Roosevelt said at the dedication of the Federal Reserve Building in Washington in 1937, "towards the maintenance of more stable employment" and "achieving greater stability of the true value of the dollar?"

The Federal Open Market Committee, made up of the Board of Governors of the Federal Reserve System plus five Federal Reserve Bank presidents, has the lawful responsibility for Federal Reserve purchases and sales of government securities, governing them – as the law says – "with regard to their bearing upon the general credit situation of the country." The Secretary of the Treasury, on the other hand, has the lawful responsibility for administering the public debt, which means issuing new securities as needed to replenish Treasury cash balances and – more largely – to cover maturities of debt.

The Federal Reserve System and Treasury have found themselves in conflict on policy many times over the thirty-six years the System has been in existence, most particularly and naturally when the Federal Reserve, as now, have seen a need to put a restraint on inflation. In 1935, a feeling that the Secretary of the Treasury had had an undue influence over Federal Reserve policy led to the dropping of the Secretary as *ex officio* member when the Federal Reserve Board was reconstituted under the Banking Act of that year. Yet the Federal Reserve have been more responsive to Treasury wishes in the last eight years than ever before.

The Background

With American entrance into World War II the Federal Reserve put their open market powers at the disposal of the Treasury to maintain a fixed pattern of interest rates. Since the war the Federal Reserve have taken some steps toward greater freedom of action. After consultation with the Treasury, Federal Reserve discount rates were increased in 1946 and 1948, and their buying rate for Treasury bills, a wartime innovation, was eliminated in 1947. The Treasury, on its part, gave the Federal Reserve leeway in

1947 and 1948 for selling short-term government securities in the open market by improving the rates offered on new Treasury issues. The principal achievement in this combination of measures was to allay the inflationary effects of the vast purchases of government bonds undertaken by the Federal Reserve in 1948 to peg their prices at par or better.

Generally through the 1946-48 period, as the Douglas Subcommittee's investigation revealed, the Federal Reserve wanted to move faster with anti-inflationary measures than the Treasury. In the summer of 1949, when a slow-down in business led the authorities to increase the credit supply and lower interest rates, the Federal Open Market Committee issued a policy statement which implied that pegging government security prices on a fixed interest scale was over and that purchases and sales thereafter would be regulated "with primary regard to the general business and credit situation". This policy statement finds its first real test in the present need to curb excessive credit expansion.

The question has been raised as to whether the Korean war should mean the abandonment of the principle announced by the Open Market Committee and a return to the frozen pattern of rates of World War II. There are people who believe that the threat of global armed conflict requires an immediate regimentation of the whole economy, shutdowns of civilian goods production, rationing of shortages, and a freeze on jobs and wages, on capital, interest, and profits. But the immediate situation we face is not total war. It could endure for years. The President, in his Midyear Economic Report, wisely rejected the path of "comprehensive direct controls which involve the consideration of thousands of individual situations and thus involve infinitely greater administrative difficulties and much greater interference with individual choice and initiative." To lessen the need for such controls, he urged that "we should rely in major degree upon fiscal and credit measures."

Action by the Federal Reserve to avoid an unnecessary increase in their government security holdings, or to produce a desirable decrease, fits this program. No weapon in the counter-inflation arsenal is more readily available, more flexible, more impersonal, and yet more pervasive in its effects.

Saving on Interest

The prime obstacle to more effective open market policy in the postwar period has been the "floating debt" — the issues coming due in the months ahead. This quite naturally has been a constant concern with the Treasury. Savings bonds and notes, kept continuously on sale, so far have brought in more than enough money to cover an $8 billion a year rate of redemptions. The biggest turnover of old debt has been in public marketable securities, maturities of which have been handled typically by the offer of new securities in exchange. The scale of the turnover is suggested by a figure of $54 billion reported in the Treasury Daily Statement as the amount of new securities issued in exchange for maturing obligations during the 1950 fiscal year. The problem of the floating debt has been self-perpetuating under a standing practice, seldom violated, of issuing short-term paper in exchange for maturities. The widest departure from this practice occurred last March-April when the Treasury issued $5.4 billion five-year 1½ per cent notes in exchange for maturing notes and bonds.

It was on an exchange offer for $13½ billion of Treasury certificates and bonds maturing September 15 and October 1 that the Treasury and the Federal Reserve came into open conflict. The interest on the maturing securities was 1⅛ per cent on two certificate issues involved, and 2 and 2½ per cent on two bond issues — an average of 1.56 per cent for the $13½ billion block. The Treasury, acting independently, decided to offer in exchange for these securities new 1¼ per cent notes, to mature October 15 and November 1, 1951. A public announcement to this effect was made after the close of business August 18. An interest saving of 5/16 of one per cent was involved — provided, of course, holders of the maturing obligations would find the new obligations acceptable.

Presumably the Federal Open Market Committee had warned the Treasury against further issues of paper in this area, which was one already congested with maturities. Exchange offerings of similar 13-month 1¼ per cent notes in June and July had had a poor response and would have fizzled except for a saving operation by the Federal Open Market Committee which bought up the maturing obligations on a large scale and later put them in for exchange to avoid an embarrassing cash drain on the Treasury. Under the market conditions prevailing in August, it was quite clear that, for the operation to succeed, the Federal Reserve would have to go into the market to buy again, probably on an even larger scale.

Federal Reserve Action

The Federal Reserve made a simultaneous public statement, August 18, that their course was "to use all the means at their command to

restrain further expansion of bank credit consistent with the policy of maintaining orderly conditions in the government securities market." The same statement announced Federal Reserve Board approval of an increase from 1½ to 1¾ per cent in the discount rate of the New York Federal Reserve Bank. Similar increases in discount rate were announced for the other Federal Reserve Banks over the following week.

For a time on Monday, August 21, there was considerable confusion as to how the Federal Open Market Committee could act to implement this policy without making a fiasco of the Treasury exchange offer. What the Committee did was to put in firm bids for the maturing securities, while supplying other securities from their portfolio. The magnitude of these operations is shown in the following table:

Federal Reserve Open Market Operations
August 16 to 30, 1950
(In Billions of Dollars)

	Holdings on August 16	Holdings on August 30	Purchases (+) or Sales (—)
Securities Involved in Exchange Offering			
Bonds due Sept. 15 and certificates due Sept. 15 and Oct. 1 (exchangeable for new 13-month Treasury notes)	$ 2.4	$ 7.0	+ 4.6
Other Securities			
91-day Treasury bills	$ 4.3	$ 2.7	— 1.6
1951 certificate and note maturities	6.9	4.8	— 2.1
1954-55 note maturities	0.5	0.3	— 0.2
Bonds maturing in 3-5 years	1.6	1.4	— 0.2
Bonds maturing after 5 years	2.6	2.4	— 0.2
Total government security holdings	$18.3	$18.6	+ 0.3

At this rate the Federal Reserve may be holding, by the time the subscription books close, the great bulk of the $13½ billion maturing obligations for exchange into the new notes. The $7 billion held on August 30 was already 52 per cent of the total outstanding amount.

The Constructive Side

The further amount of the maturing securities the Federal Reserve may be called upon to buy is staggering, and likewise the amount of securities they will have to sell if they are to sterilize the inflationary effect of the purchases. The saving grace is that, having broken the bonds of an artificial interest rate pattern, they will be in a position to exercise a positive control over the aggregate of their government security portfolio. No central bank can carry out its responsibilities without such a control.

From the standpoint of the management of the public debt, the Federal Reserve's action can be likewise constructive. This will be so if, for lack of a guaranteed low rate for one-year borrowing, the Treasury reaches out to tap the investment market for intermediate and longer term bonds, carrying the rates necessary to put them over. A misfortune of the five years past is that management of the public debt has, with few noteworthy exceptions, fallen into a routine. Because borrowing at short-term has been cheapest, the overwhelming mass of securities offered have been short-term with reliance on the Federal Reserve when necessary to insure their absorption. Favorable opportunities to refund floating debt — in 1947, 1949, and again this year — have been missed.

U.S. Credit Is Good

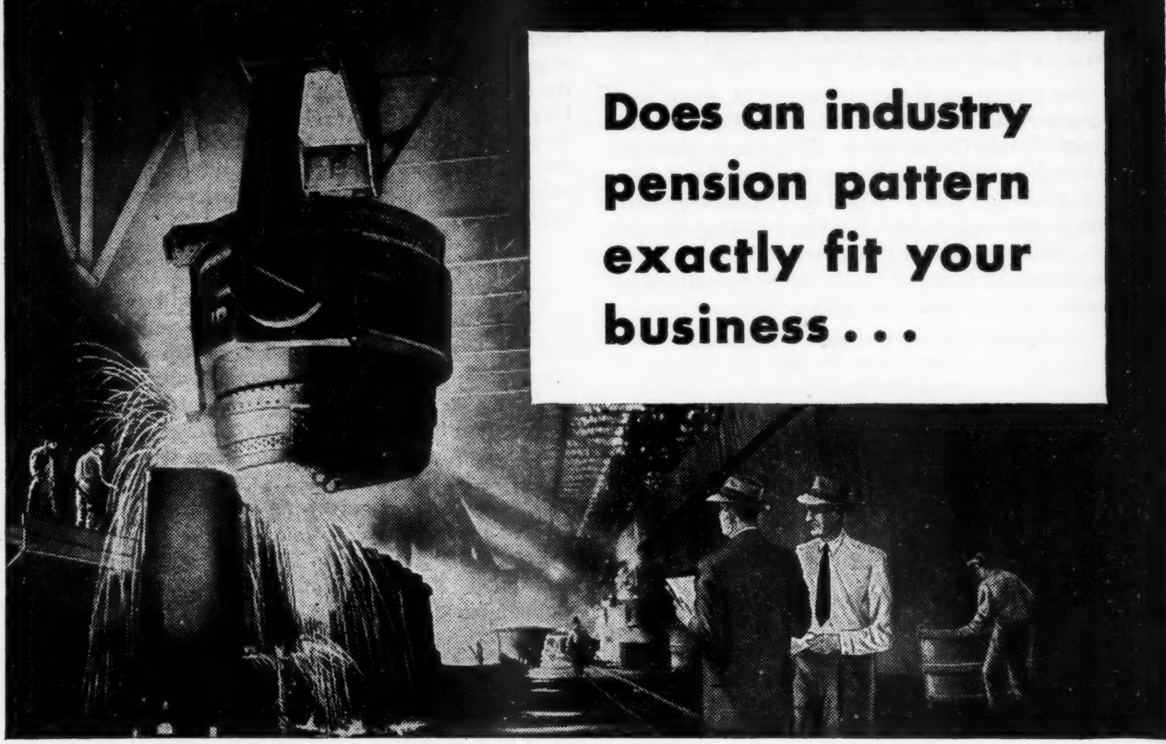
The problem is not one of the credit of the U. S. Government. It is one of choosing rates and terms that have an appeal to the investor in competition with alternative opportunities that he has. This takes some flexibility of ideas as to rates and terms on Treasury offerings. When inflation is threatening, it means more will have to be paid on newly-issued securities. Taking recourse to indirect borrowing from the Federal Reserve Banks at such a time, in order to effect a saving on interest, is to spur the wild horses of inflation. Savings on interest, contrary to the common view, are not at the expense of so-called "moneyed classes"; the latter do not look to bondholdings to produce substantial income and anyhow have to pay right back to the Treasury the greater part of what they make. Savings on interest that encourage inflation, rather, are at the expense of the people generally and of the public credit.

Conclusions

The Federal Reserve System was set up, under a set of general restrictions, to curb excesses of credit expansion or contraction in the interest of general economic stability. An effective Federal Reserve System requires, first, the appointment to the responsible posts of qualified persons with a detached point of view, and, secondly, a cooperative relationship between the Federal Reserve and the Treasury.

In the leadership of both agencies we have people of patriotism and objectivity of judgment. They can find ways to compose the highly complicated matters at issue. In the resolution of these issues the most essential ingredient is an understanding, shared not only by officials concerned but by people generally, that money must be good if efforts to earn it and save it are to be worthwhile.

Patterns in Pensions



...or will variations within the pattern mean a better pension plan for your company?

BEFORE you adopt a pension plan based on an industry pattern investigate all variations that can be made within the pattern. You may find that even a slight departure from the industry pattern will enable you to develop a pension plan better fitted to your business and employees.

The accumulated knowledge gained by our Pension Trust Division through years of pension experience is available to you. We shall be glad to estimate the cost of a pension plan for your company or to discuss with you any pension problem you may have. No obligation whatever.

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